Daiwa's View

The Fed's "dividing line between safety and destruction"

➢ Federal funds rate of 6%?

Fixed Income Research Section
FICC Research Dept.

Chief Strategist
Eiichiro Tani, CFA
(81) 3 5555-8780
eiichiro.tani@daiwa.co.jp

Daiwa Securities Co. Ltd.

People do have feelings. They'll always bring emotions and foibles to their economic and investing decisions. As a result, they'll become euphoric at the wrong time and despondent at the wrong time —exaggerating the upside potential when things are going well and the downside risk when things are going poorly —and thus they'll take trends to cyclical extremes. (Howard Marks)

Federal funds rate of 6%?

The Fed's "dividing line between safety and destruction"

In the dot plot at the June FOMC meeting, the Fed projected the federal funds rate for end-2023 to be 5.5~5.75%. Fed Chair Jerome Powell said that two additional rate hikes within 2023 would be appropriate. This appears to be a reasonable response in light of stronger-than-expected economic performance.

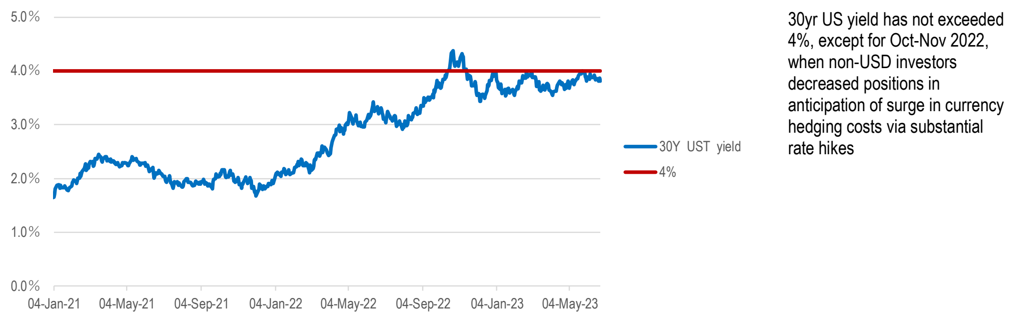
The problem is that the Fed will be forced to conduct additional rate hikes if the economy remains strong. BOJ Governor Kazuo Ueda expressed concern about the risks that would be caused by such developments, saying that they would lead to "strong downward pressure." If the Fed were forced to increase interest rates higher than 6% in 2H 2023 amid a continuation of this trend, I think it would be stepping over the "dividing line between safety and destruction" that is envisaged by two factors—the true value of the US economy and the limit for negative yields.

◆ **BOJ Governor Kazuo Ueda** (16 Jun 2023)
One more point is that, in my view, economic and price conditions are judged to be slightly stronger than previously projected, as shown by the Fed's latest revision to its projections. If this situation continues, I think that this would necessitate additional rate hikes, and that the combination of such hikes and the accumulated effects of rate hikes thus far could hold the risk of causing strong downward pressure on the economy a little further in the future.

◆ 30-year US yield has not exceeded 4% since the beginning of the year

As previously reported, the 30-year US yield has not exceeded 4% since the beginning of the year. The 30-year yield is a yield that reflects the true value of the US economy from a long-term perspective. The fact that the 30-year yield is unable to top 4% appears to suggest that 4% is an unsustainable level for the current US economy.

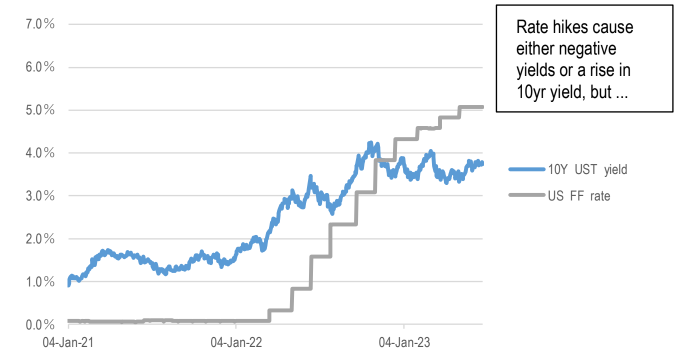
30Y UST Yield



Source: Bloomberg; compiled by Daiwa Securities.

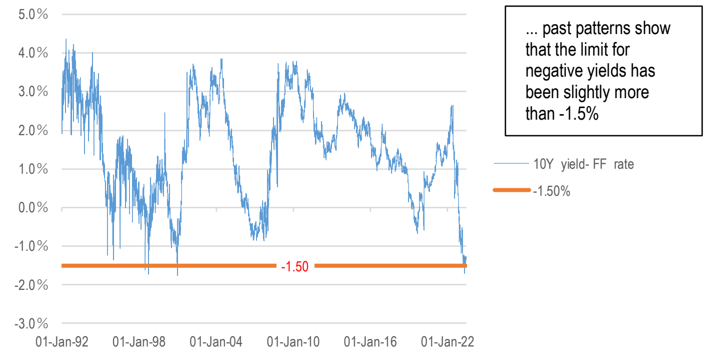
- The limit for negative yields is slightly more than -1.5%
If the Fed were to continue to raise interest rates, we would inevitably see either a rise in the 10-year yield or flattening of the yield curve (deepening of negative yields). However, there is a certain limit to negative yields. Therefore, if the Fed were to continue to implement additional rate hikes, the 10-year yield would reach a critical point above 4% at some point. Since 1992, the limit for negative yields has been slightly more than -1.5%.

10Y UST Yield, FF Rate



Source: Bloomberg; compiled by Daiwa Securities.

Limit of Negative Yields (10Y yield – FF rate)



Source: Bloomberg; compiled by Daiwa Securities.

- <u>"Dividing line between safety and destruction" is federal funds rate of 6%</u>
Currently, the market is pricing in only one more rate hike. In that case, the effective federal funds rate would be projected to be 5.35% and the 10-year yield level (after taking into consideration the limit for negative yields) would be 3.75%. If the Fed were to implement two more rate hikes in line with the dot plot, this would raise the effective federal funds rate to 5.6% and the 10-year yield to exactly 4%. The economy might be able to withstand that (unless a credit crunch occurs). However, if the Fed were to raise interest rates higher than 6% by making additional rate hikes above and beyond the current dot plot, the 10-year US yield would clearly top 4%. In that case, the level of the 10-year US yield would likely substantially exceed the true value of the economy, which is indicated by the 30-year yield. Considering this, I think that a federal funds rate of 6% would be a dangerous line, and that collapses would likely occur (such as US bank bankruptcies or a sudden credit crunch).

Outlook for Rate Hikes and Yield Level (%)

Projected timing for rate hikes		Effective FF rate	Projected 10yr yield level based on limit for negative yields	Note
Current level		5.10	3.50	
One more hike	Jul	5.35	3.75	Market pricing
Two more hikes	Nov (?)	5.60	4.00	Level of dot plot (which is not factored in by market)
Three more hikes	Depending on data	5.85	4.25	Level of 10yr yield clearly exceeding 4%
Four more hikes	Depending on data	6.10	4.50	

Source: Compiled by Daiwa Securities.

Looking at recent data, I think, in the end, cooling down employment and inflation may prove difficult unless the Fed raises interest rates to a level that "breaks something." Needless to say, if possible, we would like to see inflation cool down before the Fed steps over the "dividing line between safety and destruction." We will get a clearer idea of the likely consequences of the Fed's strategic decisions around the time of the Jackson Hole conference in late August—whether 5.75% will become the peak in the current rate hike cycle or the Fed will decide to raise interest rates higher than 6%.

IMPORTANT

This report is provided as a reference for making investment decisions and is not intended to be a solicitation for investment. Investment decisions should be made at your own discretion and risk. Content herein is based on information available at the time the report was prepared and may be amended or otherwise changed in the future without notice. We make no representations as to the accuracy or completeness. Daiwa Securities Co. Ltd. retains all rights related to the content of this report, which may not be redistributed or otherwise transmitted without prior consent.

Ratings
Issues are rated 1, 2, 3, 4, or 5 as follows:
1: Outperform TOPIX/benchmark index by more than 15% over the next 12 months.
2: Outperform TOPIX/benchmark index by 5-15% over the next 12 months.
3: Out/underperform TOPIX/benchmark index by less than 5% over the next 12 months.
4: Underperform TOPIX/benchmark index by 5-15% over the next 12 months.
5: Underperform TOPIX/benchmark index by more than 15% over the next 12 months.

Benchmark index: TOPIX for Japan, S&P 500 for US, STOXX Europe 600 for Europe, HSI for Hong Kong, STI for Singapore, KOSPI for Korea, TWII for Taiwan, and S&P/ASX 200 for Australia.

Target Prices
Daiwa Securities Co. Ltd. sets target prices based on its analysts' earnings estimates for subject companies. Risks to target prices include, but are not limited to, unexpected significant changes in subject companies' earnings trends and the macroeconomic environment.

Disclosures related to Daiwa Securities
Please refer to https://lzone.daiwa.co.jp/l-zone/disclaimer/e_disclaimer.pdf for information on conflicts of interest for Daiwa Securities, securities held by Daiwa Securities, companies for which Daiwa Securities or foreign affiliates of Daiwa Securities Group have acted as a lead underwriter, and other disclosures concerning individual companies. If you need more information on this matter, please contact the Research Production Department of Daiwa Securities.

Explanatory Document of Unregistered Credit Ratings
This report may use credit ratings assigned by rating agencies that are not registered with Japan's Financial Services Agency pursuant to Article 66, Paragraph 27 of the Financial Instruments and Exchange Act. Please review the relevant disclaimer regarding credit ratings issued by such agencies at:
https://lzone.daiwa.co.jp/l-zone/disclaimer/creditratings.pdf

Notification items pursuant to Article 37 of the Financial Instruments and Exchange Law
(This Notification is only applicable to where report is distributed by Daiwa Securities Co. Ltd.)
If you decide to enter into a business arrangement with our company based on the information described in this report, we ask you to pay close attention to the following items.

- In addition to the purchase price of a financial instrument, our company will collect a trading commission* for each transaction as agreed beforehand with you. Since commissions may be included in the purchase price or may not be charged for certain transactions, we recommend that you confirm the commission for each transaction. In some cases, our company also may charge a maximum of ¥2 million per year as a standing proxy fee for our deposit of your securities, if you are a non-resident.
- For derivative and margin transactions etc., our company may require collateral or margin requirements in accordance with an agreement made beforehand with you. Ordinarily in such cases, the amount of the transaction will be in excess of the required collateral or margin requirements**.
- There is a risk that you will incur losses on your transactions due to changes in the market price of financial instruments based on fluctuations in interest rates, exchange rates, stock prices, real estate prices, commodity prices, and others. In addition, depending on the content of the transaction, the loss could exceed the amount of the collateral or margin requirements.
- There may be a difference between bid price etc. and ask price etc. of OTC derivatives handled by our company.
- Before engaging in any trading, please thoroughly confirm accounting and tax treatments regarding your trading in financial instruments with such experts as certified public accountants.

* The amount of the trading commission cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.
** The ratio of margin requirements etc. to the amount of the transaction cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

When making an actual transaction, please be sure to carefully read the materials presented to you prior to the execution of agreement, and to take responsibility for your own decisions regarding the signing of the agreement with our company.

Corporate Name: Daiwa Securities Co. Ltd.
Registered: Financial Instruments Business Operator, Chief of Kanto Local Finance Bureau (Kin-sho) No.108
Memberships: Japan Securities Dealers Association, The Financial Futures Association of Japan, Japan Investment Advisers Association, Type II Financial Instruments Firms Association, Japan Security Token Offering Association